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A Legal Analysis of Capital Credits and Related Matters

Rural electrification under the RE Act is being carried forward, in major part, by almost a thousand separate and distinct cooperative corporations organized under the laws of the various states. Perhaps the most significant difference between a cooperative and other corporate businesses is that the cooperative customarily pays patronage refunds to its patrons. There are, of course, other distinguishing features, but without some provision for patronage refunds or the equivalent the cooperative would lose its most distinctive characteristic.

Background

Almost without exception, every electric cooperative which has borrowed from REA was organized as a "not-for-profit" corporation and some provision for patronage dividends or refunds was included in the articles of incorporation or bylaws. Looking back, it would appear that many of these provisions may not have been as explicit on the subject as they might have been. The niceties of this aspect of the organization of cooperatives seemingly gave way to other more

pressing matters such as the creation of corporations capable of bringing electric power to the rural areas as quickly as possible. Moreover, the available state laws, in many instances, were not adequate for the incorporation of this new type of cooperative. Cooperatives themselves were by no means new, but they had not been used extensively for this kind of business. Electric Cooperative Acts were being adopted in some of the states. Many of the earlier versions of these Acts, however, gave only superficial treatment to the subject of non-profit operation and patronage refunds. Then too, the body of law we have today on the subject of patronage refunds and non-profit operation was only beginning to be developed twenty years ago. So it is perhaps understandable that the best results were not always accomplished. The importance of the patronage refund principle, however, was recognized at the outset.

Dividends and Patronage Refunds Distinguished

Basic to a clear understanding of the subject at hand is the distinction between dividends in an ordinary corporation and patronage refunds in a cooperative. Patronage refunds or patronage dividends, as they are sometimes called, are not dividends at all in the ordinary sense. Dividends in the usual profit corporation represent the shareholders' part of the corporate profits or earnings and are normally divided among the shareholders in proportion to their investment in shares. On the other hand, in a true cooperative the concept of profit

is wholly inappropriate. The cooperative, after all, is a business organization operated for the mutual benefit of its members on the basis of their patronage rather than because of any financial investment therein. Its primary purpose is to provide each patron with the kind and quality of service needed at the lowest possible cost.

Of the two general types of cooperatives - purchasing and marketing - electric cooperatives fit most nearly in the purchasing category. In a purchasing cooperative, patronage refunds have the effect of reducing the cost to the patron of the service or commodity purchased from the cooperative; while in a marketing cooperative, patronage refunds have the effect of increasing the amount received by the patron for the product marketed through the cooperative. Refunds to the patron in either type of cooperative are based upon volume of business transacted and in no way depend upon stock ownership or investments.

The payment of a dividend on stock is a distribution of benefits in proportion to investment in the stock of the corporation and, generally speaking, is contrary to the basic purpose of cooperation where benefits are to be distributed according to patronage. Some state statutes providing for the incorporation of cooperatives generally do permit the payment of limited dividends on stock or membership and while some few of these statutes may specify that they authorize the formation of "non-profit cooperatives" that term would appear to be misused.

Electric cooperatives throughout the country have been organized under a variety of different statutes. Some of these statutes, although limited to the incorporation of electric cooperatives, may authorize the payment of limited dividends on stock. Virtually all electric cooperatives, however, have been organized without the power to pay such dividends, either because the statute did not permit it, or, if permitted, the cooperatives have specifically disclaimed, in their charter or bylaws, any intention of paying such dividends. It would seem therefore, that their purpose in this respect has been to operate as nearly as possible on a strict non-profit basis and to distribute the benefits of the organization on the basis of patronage.

The Problem - Applying Patronage Refunds to Electric Cooperatives

Some ten or twelve years ago electric cooperatives felt the need to do something about this phase of their program. Emphasis was shifting from the construction stage to operations and management. Lines had been built and were energized. Revenues in some cases were exceeding expectations and sizeable "net margins" or "surpluses" were accumulating. They were going businesses and the cooperatives were being asked questions about their goal of supplying area-wide, adequate and dependable electric service at cost. What about patronage refunds? Was this the time to start paying them in cash? If so, how was it to be done? There were, after all, sizeable Government loans to be repaid. If cash refunds were not possible, what was to be done?

These and other questions confronted the cooperatives at the time.

Long Term Indebtedness - Cash Refunds

There are perhaps some cooperatives that have been financed to a large extent by their members. The needed capital, in other words, has been supplied by the members through their purchases of stock or membership and little or no borrowing from third parties has been necessary. Where this has been possible, patronage refunds can be and usually are paid in cash or its equivalent each year with little or no difficulty for either the cooperative or its patrons. Even with such cooperatives, however, the need for necessary operating capital is ever present and patronage refunds are sometimes also paid in non-cash forms, thereby retaining in the business some of the cash that might otherwise be paid out. In such a case, the cooperative delivers to its patrons capital stock, revolving fund certificates, capital credits, certificates of indebtedness, letters of advice, or other similar documents which give notice to the patron of the dollar amount of the patronage refunds allocated or apportioned on the books of the cooperative to the account of the patron. Thus, there may be a cash distribution each year of the full amount of the patronage refund or a combination of cash and some form of paper distribution.

The acquisition of extensive plant facilities, however, normally requires the incurring of long term indebtedness. With a substantial long term debt to repay, the cooperative is hardly in a position to

follow the relatively simple practice outlined above. Electric cooperatives started operation with a 100% Government loan with initial member or stockholder capital limited, in most instances, to a $5 membership fee or share of stock. In other words, the heavy investments in facilities required to provide adequate service came from borrowed money - the small membership fees paid by members usually being sufficient to pay, in most cases, only a part of the organizational expenses necessary to get the cooperative started.

With loan repayments scheduled over a 35-year period, rates for service from electric cooperatives had to be such that they would cover not just the mere cost of service but also be high enough to provide funds with which to repay the loan. Their rate schedules were, therefore, designed to provide funds sufficient to meet operating costs and expenses plus the additional amount needed for principal repayments. The difference between the amount received for service and that necessary to meet operating costs and expenses produced a net margin or surplus from which patronage refunds would normally be paid by most cooperatives. Should or could an electric cooperative pay immediately these net margins to its patrons? If not, how then was a cooperative to fulfill one of its major responsibilities as a cooperative - that of making patronage refunds - and operate on a non-profit basis in accordance with its charter?

Existing article and bylaw provisions of the cooperatives were

reviewed and the incorporation statutes were reexamined with these questions in mind. Although there may have been exceptions here and there, in general the situation appeared to be as follows. Most of the bylaws provided that after all operating expenses had been provided for and a number of specified reserves established, any remaining revenues were to be distributed as patronage refunds, unless the members decided otherwise. In general, the specified reserves were to include funds for working capital, improvements, education in cooperation, new construction and contingencies, as well as funds sufficient to pay interest and principal on all outstanding notes, bonds or other evidences of indebtedness of the cooperative payable in the next following calendar year. The board of directors was given wide discretion with respect to the amount to be included in these reserves. Furthermore, there was no provision in the bylaws for the assigning or crediting to members of any interest or equity in these reserves. And, of course, before a member was entitled to any patronage refunds, the reserves first had to be set aside. Thus, subject to the establishment of certain minimum reserves such as those for the payment of interest and principal, a member's right to patronage refunds appeared to depend entirely upon a board's judgment as to the amount to be included in the other reserves. A board could, on the one hand, set aside minimum reserves and pay out the balance in cash, or, on the other hand, keep adding to the reserves thereby postponing

patronage refunds indefinitely unless the members could show that there had been an abuse of discretion.

Although there might be arguments either way, there was concern that these bylaw provisions had the effect of pushing too far into the distant future the possibility of members ever getting any patronage refunds. In any event, the patronage refund provisions seemingly lacked real meaning and, since the cooperatives were under no duty to credit to the members the amounts set aside in the reserves, there was also doubt whether the cooperatives were fulfilling their charter obligation to operate on a non-profit basis.

The Capital Credits Plan

Simply stated, the capital credits plan is a method of operation whereby a cooperative and its members and patrons agree that all amounts paid for service in excess of operating costs and expenses of providing that service are furnished as capital. The amounts so furnished are credited to the account of each patron on a patronage basis and he is notified each year of the amount of the credit. All such amounts credited to the capital account of patrons are to be retired on dissolution or sooner if the cooperative's financial position will permit.

Suppose, for example, a cooperative takes in a total of $100,000 during the year, and its expenses of operation were $90,000. The difference of $10,000 is, under the capital credits plan, capital

supplied by the patrons. If patron A's electric bills for the year total $100, he would be paying $90 to cover the actual cost of service, and $10 as capital to be used for any legitimate corporate purpose. If patron B had paid a total of $150 for service, $135 of his payments would go to cover the cost of service and $15 for capital, and so on with all other patrons, depending upon the amounts each paid for service. Of the total payments made by A and B, $10 and $15 would be paid in as capital and A and B would have an interest in that capital to the same extent as if they had each separately purchased $10 and $15 shares of stock.

The cooperative may, of course, use the capital supplied by A and B and all other patrons just as any corporation may use the proceeds of a sale of stock to stockholders. It may be invested in plant, applied toward debt repayment, or used for any other proper corporate purpose. Retirements of some of this capital will be possible when the cooperative has accumulated capital sufficient to insure the financial stability of the organization. Usually retirements would be made on a "first in first out" basis - the capital first received being first retired. Thus, if A and B had been consumers in the year in which capital was first furnished by the patrons and the cooperative is later in a position to make retirements for that particular year, the $10 and $15 credited to their accounts would be repaid to them along with the credits of all other consumers for that year before

capital supplied in later years would be retired.

For any such arrangement to be fully effective, a valid contract between the cooperative and its members and patrons is essential. Separate contracts, however, with each member and patron would not be necessary since the articles of incorporation or bylaws of a corporation create a contractual obligation between the corporation and its members or stockholders. Any non-member patron who transacts business with the corporation with knowledge of the terms of the contract would also seem to be bound by the contract to the same extent as members. The usual contract establishing capital credits is a bylaw provision reading as follows:

"NON-PROFIT OPERATION

SECTION 1. Interest or Dividends on Capital Prohibited. The Cooperative shall at all times be operated on a cooperative non-profit basis for the mutual benefit of its patrons. No interest or dividends shall be paid or payable by the Cooperative on any capital furnished by its patrons.

SECTION 2. Patronage Capital in Connection with Furnishing Electric Energy. In the furnishing of electric energy the Cooperative's operations shall be so conducted that all patrons will through their patronage furnish capital for the Cooperative. In order to induce patronage and to assure that the Cooperative will operate on a non-profit basis the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy in excess of operating costs and expenses properly chargeable against the furnishing of electric energy. All such amounts in excess of operating costs and expenses at the moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital. The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses. The

books and records of the Cooperative shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron, and the Cooperative shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account. All such amounts credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital.

In the event of dissolution or liquidation of the Cooperative, after all outstanding indebtedness of the Cooperative shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights of members. If, at any time prior to dissolution or liquidation, the board of directors shall determine that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part. Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the Cooperative being first retired. In no event, however, may any such capital be retired unless, after the proposed retirement, the capital of the Cooperative shall equal at least forty per centum (40%) of the total assets of the Cooperative.

Capital credited to the account of each patron shall be (interest)
assignable only on the books of the Cooperative pursuant to (or suc-)
written instruction from the assignor and only to successors in/ (cessors)
occupancy in all or a part of such patron's premises served by (in)
the Cooperative unless the board of directors, acting under policies of general application, shall determine otherwise.

Notwithstanding any other provision of these bylaws, the board of directors, at its discretion, shall have the power at any time upon the death of any patron, if the legal representatives of his estate shall request in writing that the capital credited to any such patron be retired prior to the time such capital would otherwise be retired under the provisions of these bylaws, to retire capital credited to any such patron immediately upon such terms and conditions as the board of directors, acting under policies of general application, and the legal representatives of such patron's estate shall agree upon; provided,

however, that the financial condition of the Cooperative will not be impaired thereby.

The patrons of the Cooperative, by dealing with the Cooperative, acknowledge that the terms and provisions of the articles of incorporation and bylaws shall constitute and be a contract between the Cooperative and each patron, and both the Cooperative and the patrons are bound by such contract, as fully as though each patron had individually signed a separate instrument containing such terms and provisions. The provisions of this article of the bylaws shall be called to the attention of each patron of the Cooperative by posting in a conspicuous place in the Cooperative's office.

SECTION 3. Patronage Refunds in Connection with Furnishing Other Services. In the event that the Cooperative should engage in the business of furnishing goods or services other than electric energy, all amounts received and receivable therefrom which are in excess of costs and expenses properly chargeable against the furnishing of such goods or services shall, insofar as permitted by law, be prorated annually on a patronage basis and returned to those patrons from whom such amounts were obtained."

The above bylaw provision replaces language dealing with the disposition of revenues and receipts of the cooperative and establishes the basic contract between the cooperative and its members. Other provisions of the bylaws may also include language clearly establishing the contractual relationship between the parties. For example, the provision obligating each member to purchase electric energy from the cooperative, and to pay therefor monthly at rates to be determined from time to time by the board of directors also states that "It is expressly understood that amounts paid for electric energy in excess of the cost of service are furnished by members as capital and each member shall be credited with the capital so furnished as provided in these bylaws." The provision in some of the older bylaws to the effect

that "termination of membership shall operate as a release of all right, title and interest of the member in the property or assets of the cooperative" is, of course, deleted since, under capital credits, a former member would not lose his right to any capital credits he may have acquired while taking service merely upon termination of his membership. He may cease to be a member with voting rights but he would not forfeit his capital credits. In addition to the bylaws, there may be instances in which a cooperative's articles of incorporation include some or all of the provisions discussed above depending upon the requirements of the incorporation statute.

In view of the renewed interest in this general subject within recent months and the increasing number of questions that have been directed to this Office, it may be helpful to include a legal discussion of some of the questions that have been raised concerning capital credits. No attempt will be made to cover all such questions, but only those that appear to arise most frequently.

First it ought to be pointed out that the term "capital credits" has seemingly become so well identified with electric cooperatives that the assumption is often made, without proper basis, that all electric cooperatives operate under capital credits. This, of course, is not the case. Much of the following discussion will apply only to those cooperatives that have adopted capital credits. For a cooperative that has not amended its articles or bylaws to provide for capital

credits, the provisions of its existing articles and bylaws would be controlling on any question concerning the disposition of its revenues and receipts or the handling of margins and surplus.

Many questions which, on first impression, may seem difficult to answer are easily resolved by reference to the basic capital credits contract in a cooperative's bylaws or articles of incorporation. The starting point in solving any question involving the rights and obligations of parties to a contract is, of course, the contract itself. With capital credits the situation is no different. The capital credits provisions of the articles and bylaws should always be consulted first.

Allocating Costs in Determining Credits

As is indicated in the quoted capital credits bylaw provision the cooperative "is obligated to account on a patronage basis to all of its patrons" for all amounts received from the furnishing of electric energy "in excess of operating costs and expenses properly chargeable against the furnishing of electric energy." Under this language, all patrons or consumers who purchase energy from the cooperative would be entitled to credits for any amounts paid by them in excess of the cost of service.

The calculation of credits on the total dollar volume of business done with the cooperative, as is customary in most cases, or the use of some fair and reasonable variation of this method would seem

permissible. A method used by some cooperatives provides for deducting from each consumer's annual power bill the direct cost of the kwh purchased by him, and for allocating the cooperative's net margin among the consumers on the basis of, and only in proportion to, the remaining balance of the payments for power. Such a method is simply one approach - and, seemingly, a fair and equitable approach - to the problem of allocating to each consumer his proportionate part of one of the items of cost before arriving at the balance available for capital credits. This and any other method which seeks to break down any of the elements of cost on an equitable and reasonably determinable basis would appear to be permissible under the bylaw provision mentioned above.

Where service is being rendered to various groups of consumers (such as industrials and commercials) under different rate structures and possibly under different cost of service conditions, it has been felt, in some cases, that in the determination of the amounts of capital, if any, furnished by such consumers, different approaches or factors should be used for these different groups of consumers. The application of good cost accounting practices may be the answer. In any event, so long as such determinations are reasonably supportable by differences in the cost of service to and the rates paid by such consumers and are reasonably designed to ascertain as accurately as possible the amounts paid by the consumers in excess of the cost of service to those consumers, no violence is done to the capital

credits bylaw or to the principle of non-profit operation.

Of course, non-profit operation would seem to require that credits for any amounts in excess of expenses due a consumer should be available to that consumer and under no circumstances apportioned among other consumers. A waiver of capital credits on the part of a particular consumer is sometimes proposed. While presumably a patron may waive his rights as a consumer to capital credits, the distribution to other patrons of any credits that may have been waived would, in all probability, be considered a division of profits, thereby destroying the cooperative's non-profit status.

Statutes in some states may require that credits or refunds be made on a patronage basis. Determining credits as above indicated, however, would not appear to be contrary to such statutes. Under most, if not all, of these statutes, patronage allocations or refunds are to be made only after operating expenses have been deducted and there should be no objection to a method that would determine and assign costs or operating expenses on as equitable a basis as possible. In any event, the usual patronage refund provisions of a state statute would not appear to be applicable where a cooperative operates under capital credits. Under the capital credits contract which the cooperative has lawfully entered into with its members, all amounts in excess of expenses are paid in and received as capital and such refund provisions clearly do not apply to receipts of capital.

Deficits

If the total amounts paid by the patrons in a particular year do not exceed the cost of service for that year then no capital would have been provided by the patrons. The patrons would, in effect, have received service at cost or less than cost if their payments for service were equal to or less than the year's operating expenses. If payments for service are less than cost the result is a deficit operation for that year. When this happens, you have the question of what to do about the deficit. Electric cooperatives do not, of course, follow the practices of making assessments against their members or patrons for losses. Looking at the contract under capital credits, it can also be seen that no provision is made for charging deficits to the patrons. The agreement calls for crediting capital to the patrons only when capital has been supplied. The situation then is comparable to one in which a corporation has, for example, sold stock at $10 a share and later operates at a loss. Each share may, at such time, be worth less than the $10 originally paid for it, but the fact remains that the shareholders provided the corporation with capital in the amount of $10 per share. Profit and loss concepts are wholly inappropriate. This should be clear if the arrangement is viewed from the standpoint of what it is intended to accomplish - namely, a means whereby the members and patrons of the cooperative may get service at cost and at the same time provide their organization with needed capital. It is

not, after all, an arrangement for the division of profits, nor could it be. The cooperatives lack the corporate power to engage in business for profit. It is possible, however, to reword the contract in such a way that deficits would be offset against capital previously supplied or to be supplied in the future.

Capital Credit Retirements

Under the second paragraph of Section 2 of the quoted bylaw provision a board of directors may, prior to dissolution, decide that the financial condition of the cooperative is such that it may start retiring capital credits. Any such retirements would, under the contract, be made on a revolving basis, that is, the oldest outstanding credits would be retired first and thereafter succeeding years' credits would be paid off in order as retirements are possible. As a safeguard against premature retirements, it is provided that no retirements shall be made that would reduce the capital of the cooperative below 40% of its total assets. In other words, assume that a cooperative had total assets of $100,000, and that over the years capital credits and other capital items such as membership fees amounted to $50,000. Under these assumed facts, the board would be in a position to authorize the retirement of $10,000 worth of capital credits since after the retirement the capital would equal $40,000 or 40% of the total assets of $100,000. Of course a cooperative would seldon if ever have cash on hand equal to its total capital, and capital credit retirements

would necessarily depend upon the availability of cash for that purpose.

While the above mentioned limitation on the retirement of capital credits is a bylaw provision and subject to change just as other bylaw or contract provisions may be amended, each cooperative would, in addition, be required to satisfy any requirement with respect to cash distributions or payments to its members or patrons that may be contained in any outstanding mortgage it may have executed. Mortgage provisions on this subject may vary, and, while, in general, it might be pointed out that the bylaw provision discussed above is more strict in this respect than the usual mortgage provision, no capital credit retirements should be contemplated, either under existing bylaws or any revisions thereof, without first consulting the mortgage to make certain that the proposed retirement would be in accordance with the requirements of the mortgage.

Members Who Move Away and Deceased Members

A member who leaves the cooperative is not entitled, by the mere termination of his membership, to an immediate return of his capital credits. Normally his credits would be paid off only at the time the cooperative is making a general retirement of credits for a particular year. While capital credits are not freely transferable, provision is made for a limited right of assignability as indicated in the third paragraph of Section 2 of the quoted bylaw provision. If a member

terminates his service and moves away he may assign his capital credits to the person who succeeds him and takes service from the cooperative. The member leaving may, of course, work out an arrangement with his successor, but this transaction normally would be of no concern to the cooperative, except to the extent that the cooperative would want to enter on its books any such assignment in accordance with appropriate instructions from the member who is leaving. Although there may be arguments the other way, it has generally been thought that a member leaving the cooperative should not be given a preference over other members who continue to take service, either by way of immediate cash payments or by applying credits against unpaid electric bills. In other words, a former member should have no greater right to a retirement of capital credits than all other members.

In cases of death, however, an exception to this general rule has been felt necessary in order to facilitate the settlement of estates. Under the fourth paragraph of Section 2 of the quoted bylaw provision, the board of directors has the power to pay to the legal representatives of a deceased patron the capital credits of the deceased patron, provided, of course, the board and the legal representatives of such patron's estate can agree upon the terms and conditions upon which such payment is to be made. Whether settlements under this provision are to be made at all is entirely discretionary with the board. Should a board decide to adopt a general policy of retiring capital credits

in cases of death, such retirements need not necessarily be for the full amount of the credits and a discount might be applied to retirements which are effected out of turn. On the other hand, payments at one hundred cents on the dollar may be more desirable in many instances. The financial condition of the cooperative and the expected or anticipated number of deaths over the years would be important factors to consider in reaching any general policy on this subject.

With respect to patrons who are no longer taking service from the cooperative, the capital credits accounts of such patrons would normally be held as inactive accounts until such time as they are to be retired. Consumers who move away should, of course, be encouraged to leave a forwarding address with the cooperative, but if they cannot be located at the time a general retirement of capital credits is to be made, their capital credit records or accounts should be retained and the cooperative could continue using the capital they had supplied while taking service until it is called for by the rightful claimants.

Income Tax Treatment of Electric Cooperatives

Agricultural cooperatives and certain non-profit organizations have always been accorded exemption from the Federal income tax. The first income tax law contained language exempting them from the tax and, down to date, these exemption provisions have been continued, although rewritten and modified in certain respects over the years. Section 501(c)(12) of the Internal Revenue Code of 1954 is the

provision that has been held generally applicable to electric cooperatives. It provides exemption for:

> "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses."

Electric cooperatives are considered "like organizations" within the meaning of this language. Tax exemption is not automatic and may be established only after a cooperative has filed an application therefor with the District Director of Internal Revenue for the District in which the cooperative is located. Most electric cooperatives have qualified for exemption under Section 501(c)(12) and exemption would continue in effect from year to year as long as the cooperative meets the requirements for exemption under this Section. In this connection, the Internal Revenue Service takes the position that exemption is not available to an organization under Section 501(c)(12) if it is authorized to pay or pays dividends on its stock or membership as distinguished from patronage refunds or capital credits.

It should perhaps be mentioned that electric cooperatives in the TVA area have, as a result of a decision of the Sixth Circuit Court of Appeals in U. S. v. Pickwick Electric Membership Corporation, 158 F(2d) 272 (1946), been held exempt under Section 101(8) of the Internal Revenue Code of 1939 (Section 501(c)(4) of the 1954 Code) as organizations "for the promotion of social welfare." This decision,

however, has not been considered applicable to electric cooperatives elsewhere.

In any discussion of the tax treatment of cooperatives it is important to distinguish between exempt and non-exempt cooperatives. Not all electric cooperatives are exempt. Amounts in excess of operating expenses received by any corporation, even though not exempt and even though not a cooperative, would not represent taxable income to the corporation if the corporation obligates itself in advance to account for or return to its patrons all such amounts in excess of expenses. There are, however, no express provisions in the Internal Revenue Code to support this proposition. But under long standing decisions and rulings of the Treasury Department and the courts, corporations have been permitted to exclude from gross income, patronage refunds, capital credits or other patronage allocations, whether or not paid in cash, where made pursuant to a preexisting contract. Litigation on this point (and there have been many cases considering the question) has involved not so much the right to exclude patronage refunds, capital credits or their equivalent from income but rather the question whether, in a given case, the corporation had properly obligated itself to make such refunds without the necessity of further corporate action. An exhaustive list of citations and a discussion of cases would seem to be outside the scope of this memorandum. One judicial definition of a cooperative, however, by the Ninth Circuit

Court of Appeals in American Box Shook Export Assn. v. Commissioner, 156 F(2d) 629 (1946), which emphasizes the importance of a preexisting obligation, is worth quoting:

> "In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its by-laws, or some other contract." (Emphasis supplied.)

Non-operating Revenue

The receipt by a cooperative of non-operating revenue such as interest or rental income sometimes raises the question whether such non-operating revenue might not be included as a part of capital credits assignable to patrons. Under the capital credits bylaw contract, the source of capital is limited to the amount received "from the furnishing of electric energy" and if non-operating revenues are to be included as a part of capital credits, appropriate changes would be required in the bylaw contract. In connection with any such proposal, there is for consideration the question whether the mere fact that a cooperative has profitably invested its funds offers sufficient justification for crediting to the patrons the return on that investment. It is possible that such an arrangement would be held to be an assignment of income or the right to receive income which the courts have held ineffectual as a means of insulating the assignor from income tax liability. See Lucas v. Earl, 281 U.S. 111, and the line of

cases on the same general subject, including Commissioner v. Sunnen, 333 U.S. 591. In addition, and perhaps of much greater significance, is the possibility that such an arrangement might jeopardize the effectiveness of capital credits insofar as such effectiveness relates to the tax status of cooperatives.

For example, if a non-exempt cooperative allocates to its patrons, as a part of its plan of capital credits, amounts received as interest or rental income, the position might be taken, under the rule of Lucas v. Earl, that the obligation to account for and return to the patrons the interest or rental income was an agreement to share profits with the result that the cooperative would be taxable on that income. In such a situation, there would appear to be some question whether the obligation to credit to the patrons the amounts in excess of expenses from electric sales would be recognized and held separable.

Interest, rentals or gains on sales of property, usually arise as a result of transactions with third persons and would represent what might be called non-mutual dealings quite unlike a cooperative's transactions with its patrons which are on a mutual basis. There would appear to be some question whether a cooperative could obligate itself to return to patrons the proceeds of dealings with third persons without destroying its non-profit character. This would seem to be true even after taking into account the argument frequently advanced that such an arrangement has the effect of merely reducing expenses and

thereby increasing the amount otherwise available for capital credits.

Necessity for Notice to Patrons

The first paragraph of Section 2 of the quoted capital credit bylaw provision states that the records of the cooperative shall be kept so that at the end of each fiscal year the amount of capital, if any, furnished by the patrons will be credited to the account of each patron. There is also the statement that the cooperative will "within a reasonable time after the close of the fiscal year notify each patron of the amount of capital" credited to his account. An annual notice to patrons would, therefore, be required under the terms of the usual capital credits bylaw contract. Failure to comply with this provision would, of course, be a violation of the bylaws.

Income Tax Status of Capital Credits to Members

From the individual member's point of view a discussion of the income tax status of capital credits may be in order. In some cases a consumer's individual Federal income tax liability may be affected by the allocation of capital credits. For the patron of an electric cooperative who uses electric energy for non-business purposes, capital credits would in no way enter into his income tax calculations. It simply has the effect of reducing the cost of the electricity he purchased for personal or household use. In the majority of cases, however, a consumer of an electric cooperative probably deducts all or a major portion of his electric bill as a business expense. By receiving

capital credits, the business expense deductions of such a patron would, in theory at least, be reduced by the amount of the credits and the patron's net income increased by that amount.

Although there appear to be no rulings or decisions of the courts dealing specifically with capital credits, a general discussion of the Treasury Department's Regulations with respect to patronage refunds and some of the court decisions on the question may be helpful. Under the Treasury's Regulations, patronage refunds are considered paid to the patron when remitted in cash, certificates of stock or when credited to the patron's account. A patron is required, under the Regulations, to take the refund into account at face value (even though not paid in cash) in computing his income tax for the year in which the refund is made, either by reducing his business expense deductions by the amount of the refund or by adding patronage refunds to income. The patron, of course, must have timely and proper notice of the amount involved before he could be expected to take it into account in his return. There are, however, a number of recent court decisions which do not follow the Regulations insofar as they require non-cash refunds to be taken into account at face value. In some of these cases the courts have found that the credits or patronage refund certificates in question had no fair market value and therefore they did not have to be taken into account by the patron in his individual income tax return.

Of interest in this connection, but with particular reference to accrual basis taxpayers, are the cases of George Bradshaw, 14 T.C. 162; Harbor Plywood Corp., 14 T.C. 158, affd., 187 F.(2d) 734 (C.A. 9th, 1951); and Long Poultry Farms, Inc., 27 T.C. No. 120. In the Bradshaw case, purchasing rebates issued in the form of registered redeemable interest-bearing notes were held accruable income to the members in the year when issued. In the Harbor Plywood case the taxpayer was a member of an export cooperative, which during the year in question, issued to the taxpayer, credit memoranda representing its pro-rata share of the excess of the cooperative's income over its expenses for each year. The amounts represented by the credit memoranda accrued and were held taxable in the years when received, although the cooperative withheld payment for sometime. In the Long Poultry Farms case the court held that a patronage refund credit allocated to the account of a member who kept his books and reported his income on an accrual basis was an item of income to the member at its face amount for the year in which the allocation was made. The court found that there was a reasonable expectation that the amount represented by the credit would be paid - only the time of payment being uncertain.

With respect to taxpayers on a cash basis, the following cases are of interest. In one case members of a cooperative were held not to have received taxable income upon the receipt of revolving fund certificates which represented funds retained by the cooperative

from marketing operations on behalf of its members, the proceeds of which were not made available to such taxpayer-members. P. Phillips, 17 T.C. 1027. On appeal, however, the Tax Court's decision was, on stipulation, remanded to the Tax Court with direction to vacate its decision. The reasons for the stipulation or the remand do not appear. (C.A. 5th, 1954). In William A. Joplin, Jr., 17 T.C. 1526, members of a farmers' cooperative were held not taxable on proportional shares of the cooperative's net earnings which were credited to capital reserves, but in respect of which no certificates or other evidence of such interest were issued. In Est. of Wallace Caswell, 17 T.C. 1190, where transferable certificates of a growers' cooperative were issued to patrons as evidence of their interest in the cooperative's capital reserves, such certificates, to the extent of their fair market value, were held taxable to the patron upon receipt. The Ninth Circuit Court of Appeals, however, reversed the Tax Court holding that the certificates were mere evidences of contingent rights in the reserves and did not represent income to the patron. 211 F.(2d) 693 (1954). In B. A. Carpenter, 20 T.C. 603, affd., 219 F.(2d) 635 (C.A. 5th, 1955), a marketing cooperative retained amounts for capital purposes which were evidenced by revolving fund certificates retirable at the sole discretion of the board of directors. It was held that the certificates which had been issued to

the taxpayer had no fair market value and did not represent income to the member in the year in which issued.

This memorandum does not - nor could it - cover every question which may arise in this field. It is primarily a discussion of fundamentals and the more common general problems. The Office of General Counsel will be happy to assist in any way it can with respect to any special questions.

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